CAPITOL
INVESTMENT ADVISORS
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Strategic Report

Idaho State Treasurer Diversified Bond Fund

For the Period Ending June 30, 2009

Total Return Commentary

The U.S. Treasury yield curve "steepened" significantly during the second quarter of 2009. Treasuries with maturities less than one year experienced essentially no change in rates while 2-Year Treasuries rose 0.31% and 10-Year Treasuries rose 0.87%. The difference in yield between 30-Year Treasuries and 2-Year Treasuries increased the past twelve months from 190 basis points to 322 basis points.

The increase in rates across most of the curve resulted in a negative movement for treasuries, with the Intermediate U.S. Treasury Index down 2.1% for the quarter. This, however, was more than offset by a roaring credit sector. U.S. Intermediate Corporate bonds were up 9.1%. The credit sector however was not the best performing sector. The Commercial Mortgage Backed Index was up 12.5% for the quarter. The Barclay's Capital Intermediate Aggregate A+ Index (the portfolio's market benchmark) posted a positive return of 1.1% with a year-to-date total return of 1.9%

During the first quarter, the Diversified Bond Fund was up 1.8% with a year-to-date total return of 2.9% (including sweep cash). The outperformance for the quarter as compared to the index was due to a conservative maturity/duration stance and solid performance of the corporate securities held in the portfolio. Since inception in June of 2000, the DBF (including cash) has returned 61.6% which corresponds to a 5.6% annualized return. The current yield to maturity for the Diversified Bond Fund is 3.2%. The effective weighted average duration for the portfolio is just 2.3 years. The duration of the comparable index is 3.3 years. The weighted average duration of the portfolio has been decreased in anticipation that longer-term rates will trend higher from current levels.

Portfolio-Specific Issues

Total return in a fixed-income portfolio is made up of income and principal fluctuations due to changes in interest rates. In a rising interest rate environment, the principal value of fixed-income securities can decrease. If participants invest principal for a time period shorter than the portfolio duration they could face a situation where they could lose money on a total return basis. Accordingly, participants are encouraged to place only assets that are expected to be invested over a 3.5 year or longer period in The Idaho State Treasurer's Diversified Bond Fund. In addition, participants are encouraged to reinvest as much of the income as possible to fully participate in the benefits of the Diversified Bond Fund and its focus on total return.

Market and Portfolio Commentary

The fixed income markets continued to be quite volatile during the second quarter. There were major rallies in some sectors as the pace of severe negative economic news slowed somewhat. The credit markets were very spooked at the beginning of the quarter which was reflected in wide spreads to treasuries. Concerns over economic and corporate-specific viability were mitigated somewhat by less negative news and the credit markets rallied as a result.

We have significant concerns regarding the economic and fixed income environment in the intermediate to longer-term. Large federal and trade deficits, a potentially weakening dollar, as well as under supply/increasing demand issues for commodities including energy and raw materials could result in higher inflation and rapidly rising interest rates in the U.S.

We will continue to maintain a duration significantly less than the benchmark. We will overweight the mortgage sector, and look to overweight the U.S. government agency sector as we feel these provide the best current relative value. We will continue to look for opportunities in the credit markets, focusing on securities at least AA rated by national rating organizations.